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CURRENCIES AND CREDIT MARKETS

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It is beguiling to contemplate the strong economy of recent years in the context of very large deficits and to conclude that the concerns about the adverse effects of the deficit on the economy has been misplaced. But this argument is fanciful. The deficit already has begun to eat away at the foundations of our economic strength. And the need to deal with it is becoming ever more urgent. To the extent that some of the negative effects of deficits have not as yet been felt, they have been merely postponed, not avoided.

Alan Greenspan, Statement to the Deficit Commission, November 16, 1988.

HIGHLIGHTS

The world economy is again at a cross-road. After two years of a synchronized world economic boom, trends are beginning to diverge.

The over-heated and imbalanced economies of the Anglo-Saxon bloc appear to be in the midst of a marked slowdown originating from the demand side.

Could it be that an emerging "Amerisclerosis" has now come to eclipse "Eurosclerosis"? We see every sign of it. The health and strength of the EEC economy shows that it is time to cast off that latter anachronism.

Underneath the camouflage of short-term cyclical effects, it is evident that the secular trend of U.S. productivity remains a cause for serious concern. It is only strong employment growth that has exaggerated GNP comparisons. Now employment growth is set to slow.

The prospect of continuing high external deficits and relatively high inflation for the U.S. (and other deficit nations) is bound to further challenge the faith of international credit markets.

So far, the high interest/exchange rate policies of the deficit countries have failed to materially check economic activity and soften external imbalances. Huge capital inflows have derailed the effects of domestic monetary policy, causing perverse effects on currencies and scarring the structure of deficit economies.

It is only the prevailing positive bias in the perceptions of international credit markets that continues to sustain negative developments. How long can worsening excesses and imbalances be held together by the fragile thread of confidence?

The difference between today's international lending frenzy and the one associated with the Third World Debt debacle is that this time the currency markets will face the brunt of any crisis.

"AMERISCLEROSIS": THE ECLIPSE OF "EUROSCLEROSIS"

The world economy is again at a cross-road. After two years of a synchronized world economic boom, trends are beginning to diverge. While Continental Europe, Japan and the newly industrialized countries (NIC's) of the Far East continue to boom along at their capacity limits, the over-heated and imbalanced economies of the Anglo-Saxon bloc appear to be in the midst of a marked slowdown originating from the demand side.

Interestingly, within that former group of more ebullient economies one participant still remains widely unacknowledged. After all the talk about the economic "miracles" that have happened elsewhere in the world, it is now long overdue to take note of the excellent economic performance of Europe. In 1988, average growth for the European Economic Community (EEC) was almost 3.5%, the best performance since 1978-79. Yet, at that time, average inflation was three times today's level. One has to go back more than two decades to find a combination of output growth and recorded inflation as desirable as today. And prospects for 1989 remain highly favourable for a continuance of this strong performance mix.

European Expansion Has Been Soundly and Broadly Based. But by far, the most important feature of the healthy upswing in Europe is that it has been fuelled by investment. Between 1984 and 1988, business spending on plant and equipment has risen an average of 7% each year, comparing admirably with an annual growth rate of only 0.8% between 1979 and 1984. The factors contributing to this resilient investment boom have been many including a tremendous improvement in profitability, historically high levels of capacity utilization and, probably, preparation for Europe 1992.

A further testament to the health and sustainability of the European recovery are two further features: first, inflation risks in most countries remain reasonably limited: and secondly, imbalances between EEC countries have been generally contained, with three exceptions: Britain, Denmark and Greece.

Things Are Better Than They Appear. At first sight, we realize that the economic growth rate just mentioned may not impress many observers. To wit, many American reports tend to stress that despite the recent supply-side improvements and the surge in economic activity, growth rates in Europe are still well below those recorded during past years in the United States and some other countries. No doubt, this general perception - American dynamism versus European sluggishness - has also contributed to the strength of the U.S. dollar by attracting capital from abroad.

Yet, these popular comparisons are unbelievably simplistic and grossly misleading as far as relative economic health and underlying strength is concerned because it doesn't take into account wide differences in population and labour force growth. Between 1973 and 1988, actual labour supply increased 11% in the

EEC while expanding by as much as 34% in the United States. In the case of Germany, both population and the labour force actually declined, the latter by 4%.

Germany: The Lagging Mule? Repeatedly, one reads about the growth-laggard Germany while America reputedly bursts of innovation and job growth. As long as one narrowly looks at overall GNP growth, this claim seems correct. It is true, for example, that between 1973 and 1988, German real-GNP grew by 31.4% whereas U.S. GNP forged ahead by a seemingly incomparable 48%. But in the case of Germany, what about the fact that all of this economic growth was attributable to boosts in output per worker? In the United States, almost to the complete contrary, approximately 70% of GNP expansion was due to the increase in the number of workers - not output per worker.

The record of strong job-creation has been the proudest boast of the Reagan and Carter administrations. But, the hard truth is that in reality this employment boom and the associated high GNP growth rates have camouflaged the virtual collapse of productivity growth since 1973.

PERSPECTIVE ON U.S. PRODUCTIVITY

To understand the growing debacle of low productivity and high inflation in the U.S. economy, one needs a longer-term perspective. Between 1960 and 1973, the U.S. economy recorded average annual GNP growth of 4%. Of this percentage, 1.9 was attributable to employment growth and 2.1 to productivity improvements. In the following years to 1979, average annual GNP growth was still 3%, but below the surface a startling change in its composition had taken place. Job growth now accounted for 2.5 points and productivity growth for no more than 0.5. More members of a family household had to work in order to improve their material levels of living. The years following 1979 up until 1982 were even worse as productivity actually declined.

It was the heralded and central goal of Reaganomics to reverse this process and raise the flagging productivity performance of the American economy. This endeavour has since proven to be a false hope. Apart from the modest temporary effects of the business cycle, there has been no real underlying improvement in productivity growth.

In fact, by 1988, productivity growth was back to zero if one measures GNP growth from the fourth quarter of 1987 to the fourth quarter of 1988. What productivity improvements there were, ended abruptly with the wane of the export boom early in the year. As productivity growth vanished, unit labour costs soared 5% measured fourth-quarter over fourth-quarter.

Cyclical Versus Secular Effects on Productivity. To grasp the present predicament of the U.S. economy, one must first recognize

the significance of the longer-running backdrop of secular dimension. In assessing present prospects for both the U.S. economy and the dollar, we ought to distinguish between two different sets of dynamics. One is of a cyclical nature and the other is structural - that being the collapse of productivity growth in the 1970s. Taken apart, it is apparent that a miserably slow pace of productivity improvement is giving the economy an inflationary bias.

At the end of a cycle, declining productivity growth typically boosts labour unit costs. By all appearances, that seems to be happening in the United States presently. From that perspective, the recent slowing of productivity might be discarded as a temporary cyclical phenomenon. But the trouble is that in the case of the United States, this downturn is taking place in the context of a long-term decline which has been temporarily obscured by the a strong cyclical upswing. Considering that U.S. industrial production rose by 40% between 1983 and 1988 with corresponding huge gains in capacity utilization, it is outright alarming to note that overall productivity increments stayed miserably low at an annual average of around 1%.

A cyclical fall in productivity is now compounding the long-term decline in productivity growth. Come the 1990s, its not far-fetched to think that markets and the media may turn their focus to the phenomenon of "Amerisclerosis" and begin marvelling at the healing of the "Eurosclerosis".

To make matter worse, sluggish or even absent productivity growth now coincides with another factor that will impair future GNP growth. It is a sharply slowing growth rate of the available labour force. In 1987 the labour force grew 2.7% and in 1988 by 2.3%. But now it is down to a long-term range of 1.5 -2.0% per annum.

Taking into account the sluggish productivity performance with this downturn in labour force growth, U.S. potential economic growth may hardly exceed 2.0% per annum in coming years.

In 1980, it was agreed that the United States must dramatically increase its investment. Tragically, America has since cut its net investment rate - even in the face of sharply rising employment - to a new record low of 4.7% of GNP, that being down from an already low average of 6.7% in the 1970s.

THE LONG-TERM PRODUCTIVITY DILEMMA

Cross-sections of recent-year GNP growth in the U.S. reveals two incipient and damaging trends. First, there has been a sharp rise in consumption at the expense of investment and the trade balance. Between 1982 and 1987, domestic consumption as a percentage of GNP was one full percentage point higher than domestic production - largely as a result of huge foreign capital inflows which stimulated domestic spending.

This "overconsumption" is changing the whole structure of the U.S. economy. While high interest rates and exchange rates have so far failed to materially check overall economic growth, they have set in train a damaging change in the whole production, employment and investment structure of the economy. What happens is that the service sector, which is not as sensitive to interest and exchange rates, expands disproportionately relative to manufacturing and export sectors.

The Nature Of the U.S. Employment Expansion. For most deficit economies, especially the U.S., it's undeniable that employment growth has been awesome. But what of the quality of this growth? As we've already pointed out, economic policies have favoured the relative performance of service sectors. Almost all of the employment growth has been generated in the service sector. This is a crucial development which carries longer-running implications that few observers outside the United States recognize.

A prevalent myth is that the rapid U.S. growth in service jobs reflects expansion in advanced technologies sectors. Exactly the opposite is true. There are two very different kinds of services: low-skilled and poorly paid jobs that are generally geared to the pampering of the domestic consumer, and well-paid services that are either business or export oriented. Only a fraction of new job growth has been contributed by this latter category. Rather, the great bulk of new employment has been in unskilled consumer-related jobs - personnel working short hours at low pay in retail stores, fast food restaurants, hospitals, nursing homes, public service, and home service to name a few. It is illuminating to note that only 60% of the American labour force now works full-time in year-round positions.

While the Great American Job Machine is churning out a seemingly infinite number of low-wage jobs, employment commanding a high level of education and high pay is getting scarcer and scarcer. As a result of this low-wage "bubble", the average wage of employed persons in American shows a persistent decline. Real wages have fallen 16% since 1973.

MANY LONG-RUNNING IMPLICATIONS OF PRODUCTIVITY/EMPLOYMENT DEBACLE

Why have we delved into the complexities of employment fundamentals? Does it have any relevance for the performance of financial markets and currencies? We think they are of crucial importance for anyone who looks a bit further than the next few weeks. The reason is - to quote Alan Greenspan -"that the long run is rapidly turning into the short run". What we have not yet expressly pointed out, although it is obvious, is that the surge into low-paid service activities has an intriguing corollary: the relative decline of America's industrial capacity.

How can one speak of a decline in America's manufacturing base in face of such an apparent boom in employment and economic growth? We again must warn observers to distinguish between the effects of shorter-running cyclical forces and slower-moving secular trends ...in other words to differentiate between the movements of the surf and the tide. The cyclical surge of the surf has temporarily raised the water level even as the undertow of the tide continues to move out.

Much Evidence of a Declining Secular Trend. The direction of the tide is plain to see by just looking at the average water level. The evidence lies in bloated imports and weak exports. Since 1980, American industry has been losing the beach front to foreign competition both at home and in world markets. The relative comparisons are telling.

Since 1973, U.S. manufacturing imports, as a share of domestic manufacturing production, have risen from 5% to 12%. At the same time, U.S. exports rose about 20% less than world exports despite the fact that America's share of world GNP has remained steady at roughly 23%. Clearly, this is an alarming development. It is even more sinister when one takes into account the relatively high rate of employment growth, up 34% since 1973.

The Continuing U.S. Trade Deficit Is Evidence of an Embedded Problem. It is clear to us that the U.S trade deficit is largely the result of structural causes. While the industrial sector is squeezed from the trade side, rapidly expanding service-sector employment provides little that is internationally saleable. In the meantime, aggregate income growth in the service sector (although low-paying on a per-capital basis) generates further demand for imported goods.

Recent U.S. trade figures seem to give the impression that there has been an improvement over year-ago levels. But that's an optical illusion coming from a cosmetic switch in the publication of import data from the old CIF basis to the FAS basis, which has the effect of reducing the level of imports and the deficit by around $1.5 billion per month. Its counterpart, of course, is a correspondingly higher service deficit. But, that is published only every quarter.

In the meantime, Japan has already reported its trade surplus with the United States for the month of March. It showed a sharply widening chasm. Clearly, the U.S trade deficit appears to be worsening.

PROSPECTS FOR INTERNATIONAL IMBALANCES: A SHIFT IN CONSENSUS?

Reading recent brokerage and press reports (both American and British), it strikes us that a new theme is now gaining prominence. It is the question of whether or not the authorities of the major deficit countries (United States, Britain, Canada, and Australia) will manage a "soft landing" for their economies - a scenario in

which inflationary pressures are brought under control without either a prolonged recession or any shocks to the financial and exchange markets.

While this subtle, but novel, twist in the discussion is quite a far cry from the prior euphoria which foresaw nothing but buoyant economies as far as the eye could see, most assessments still end with one and the same "happy-go-lucky" incantation: "Don't worry. Neither budget nor trade deficits really do matter. The world is just too eager to finance them indefinitely and "risk premiums" in the form of higher interest rates aren't even necessary".

Admittedly, those (including ourselves) who have been warning of an eventual "hard landing" of the U.S. dollar and the other high-yielding currencies (spawned of yawning external deficits) were proven wrong (or perhaps not yet proven right?) in 1988. But how long is one year in these glacial matters? Let's not forget that it wasn't so long ago (in 1987) that huge dollar purchases were required by foreign central banks to finance the U.S. current account deficit and prevent the dollar from crashing.

SIDE EFFECTS AND THE FUNDAMENTALS OF CURRENCY STABILIZATION

True, governments and central banks have been tremendously successful in stabilizing exchange rates since then. But, these efforts have had their price. By neutralizing the risk and fear of exchange volatility, what has happened instead is that interest rate differentials have become the key determinant of exchange rate movements.

What's wrong with that? One thing: given the fact that deficit countries have high interest rates and that surplus countries have low interest rates, this artificial exchange rate stabilization essentially ends with the perverse effect that currencies move contrary to their underlying fundamentals. As capital flows are powerfully lured by the siren call of high interest rates - even to the point of overwhelming trade deficits - the currencies of these countries appreciate. Meanwhile, the low-yielding currencies of surplus countries depreciate in complete disdain of what would otherwise be considered attractive fundamentals.

With the appearance of this "new age" market mechanism, one may well have to postulate a new rule of thumb: for a given country, the greater the deficit and therefore the higher the interest rate level, the stronger its currency.

Not only is that lunacy, of course, but there's much more that boggles the mind. For example, spiralling short-term interest rates now seem to have less impact on these deficit economies than usual, one result being that these unprecedented interest rate differentials persist, which then in turn maintain upward pressure on currencies. How is it that Australia comes to the point of needing to endure interest rates near 20%.

In reality, there is no reason to be puzzled. It should be obvious that such large capital inflows must essentially undermine the effectiveness of domestic monetary policy. That happens in three ways: first, foreign inflows add directly to the domestic credit supply; secondly, inflows have been a major factor in driving a wedge between short and long-term interest rates by artificially holding long-term rates down; and thirdly by helping to sustain or drive up asset prices thereby contributing positive wealth effects.

Yet, all the while that huge foreign capital inflows defray the impact of domestic monetary policy, these recipient countries have such relatively high inflation rates and outsized external deficits that their central banks simply have to intensify tightening activities until both the trade balance and inflation show improvement. As stated in our last letter, authorities are forced to "err on the side of restrictiveness" which almost guarantees a monetary "over-kill".

FUNDAMENTALS VERSUS THE MOMENTUM OF CONFIDENCE

At issue is the question of whether or not there will be a "hard landing". But a hard landing for what: the economies, the currencies or their financial markets? We read reports which explain that there might well be a hard landing for some economies, but that this would be unlikely to involve a hard landing for the currencies and the financial markets. Actually, we think that it will probably be just the reverse. There is one simple reason why we are inclined to take that view. The whole stability of financial markets in these countries hangs only on the fine thread of confidence.

For reasons already explained, recent trends in currency exchange rates have been predominantly determined by interest rate differentials, regardless of the size and direction of gargantuan trade imbalances. Yet, in reality something more is required that just high interest rates to cause this reverse effect on exchange rates. An essential second condition, whether correct or misconceived, is the basis of a generally positive and optimistic perception of the economies and economic policies of the debtor countries.

And what is needed to create and facilitate such sentiment is, as always, faddish theories that justify and rationalize away the danger of virtually endless borrowing and lending. And whenever bankers want "theories" to make a profit, there is never a lack of economists to deliver them with many wishes of goodwill for all mankind. As Voltaire was supposed to have said, "whenever a banker jumps out of the window, follow him - there must be a profit."

True to form, such theories blossom as never before. The least of this poisonous bait is that budget and trade deficits don't matter anymore because the world is awash with "return-hungry" liquidity to finance them. Other theories even glorify large trade deficits

as a sign of economic dynamism that reflects superior investment opportunities and an excess of domestic investment over savings. For example, one might remember that not so long ago, Mr. Nigel Lawson, Britain's Exchequer of the Treasury, liked to boast that his country's trade deficit was a problem of success - not excess. And far away in the other hemisphere, the same accolade was heard from Australia's counterpart, Mr. Paul Keating.

Our knowledge of history tells us that such hoary theories and their associated complacency are precisely the stuff of which all crises have been spun. Every crisis has had one and the same basic element: spending in excess of the means of revenue. The only thing that varies are the fables that are told to sustain the borrowing and lending of perpetual prosperity. The "kicker" may be that "something is different this time", or the "new country of the future", the modern day magic of supply-side economics ...and on and on. If these stories are believed long enough, and they sometimes are, the eventual result is another one of the devastating financial crises that have so often punctuated history with remarkable regularity.

Third World Debt: An Illustration of Confidence Deferring the Outcome of Fundamentals. How many years was it that the "devil-may-care" assumptions (of governments, banks and economists), that soaring debts of developing countries could be serviced continuously by indefinite new borrowing on the financial markets, went virtually unchallenged? And how long was it that those few who warned of coming disaster were ridiculed almost into repressed silence?

For six or seven years the debts of these countries were rolled over, greased with lucrative fees all the while. So long as everyone believed that the process could go on, it went on. It is more than just happenstance that the root of the word "credit" is the Latin verb "credere", meaning "to believe". More and more credit needs evermore belief.

All of a sudden, in 1982, the window on markets that had previously lavished generous funds on these developing countries snapped shut like a Venus fly-trap. While it took many years of reckless lending and borrowing to create the huge debt monster, it took just weeks to trigger the crash and free the juggernaut from its fragile cage of credit confidence.

There is a Contrast Between Third World Lending and Today's Deficit Lending. One of today's new "theories" asserts that there is no parallel between the development of the Third World debt problem and today's boom of American debt because U.S. debts are primarily denominated in its own currency. Therefore, the conclusion follows that America is not dependent on earning an export surplus to service its debt. If necessary, this debtor can resort to printing more money.

As a matter of fact, the United States is not alone in enjoying that "advantage" anymore. Today, nearly all countries borrow in their own currency. Supposedly, it is another "great innovation" of international finance that creditors have devised ways of assuming exchange risk. That's absolutely new in the annals of financial history. But, the motives are obvious. Foreign-currency lending provides fatter interest rate differentials and profitable insurance premiums. The fact is that such huge interest rate differentials, as have already persisted for so many years, have never prevailed for so long at such high levels.

Nevertheless, this international lending mania will end just like any other lending frenzy. The important thing to realize this time is that it is the currency markets that will essentially bear the biggest brunt - that being the critical difference to the Third World debt crisis. The only questions that remain is what the ultimate trigger might be that will finally disrupt capital flows and/or the possible sequence of events. What would be the things to look for?

DEVELOPMENTS THAT MAY ALREADY BE DOCUMENTING A FAMILIAR PATTERN

Recent events may already contain important clues and lessons. In February, the whole group of high-yielding currencies came under pressure. The one general reason apparent was the fear that the German Bundesbank would further tighten its screws and raise its interest rates. It didn't. In the case of sterling and the Australia dollar, the additional tremors of unexpectedly bad trade and inflation numbers were at play. More significantly for Australia, their finance minister, Mr. Keating, made a public remark that signalled his desire to see a lower Australian dollar. Taken together this was enough to unnerve the currency markets. As is well known by now, within barely three days, the Australian dollar lost almost 10% of its value.

What then happened after this accident is also revealing. Mr. Keating obviously thought that the exchange markets had given him more than he wanted. In order to stabilize the Australian dollar at its lower level, the central bank slammed on its parking brake. Since then, short-term interest rate have been forced up more than 2 percentage points into the "high teens" while long-term bonds went into a tailspin. Recent one-year "euro" bonds now offer yields of 20% and more.

There is a factor in this situation that applies far beyond Australia, we think. It is the overriding importance that deficit countries attach to the maintenance of a strong currency as a means of suppressing inflation or, as we put in our last letter, "exporting domestic inflation pressures onto somebody else". With inflation in Australia currently near 8%, a much lower currency would certainly be an unwanted aggravation.

Canada: Another Supporting Actor. Canada is another "picture perfect" example of this economic ruse that's endemic to the deficit countries. Back in early 1986, following a vicious slump in its currency, the Central Bank of Canada promptly widened interest rate differentials. Against its nearest neighbour, the United States, both short and long-term interest rate differentials approximately doubled and have stayed there fairly consistently ever since. No doubt, that policy has been a major reason why the Canadian dollar began a long and steep ascent against the U.S. dollar, rising from less than US $0.70 to well over US $0.84 recently.

Meanwhile, the mills of consumer and business credit began pumping and reached a peak growth rate near 14% in 1988. Recent credit growth is still above 12% year-over-year, dramatically higher than that of the U.S. But, it should follow as no surprise that relative U.S./Canadian inflation rates have so far remained fairly even, thanks to the ever appreciating Canadian dollar.

It's also little wonder, that part of this process has involved huge inflows of foreign capital. For one, these inflows have been needed since Canada's current account began gaping sharply earlier in 1985 and continues to widen because of its disproportionately large external debts, persistently high budget deficit and lack-lustre trade performance. Secondly, interest rates differentials have been attractive, drawing voluntary foreign capital. It's telling to note that foreign capital inflows into Canada's fixed income markets over the previous twelve months are the largest in its history. Is Canada next in the daisy chain?

For Canada, the suspense now builds. Beginning glimmers of economic weakness now appear and only now, this late in the business cycle, have government officials mustered up the zeal to begin slashing a huge budget deficit which otherwise would again appear to be growing back to 5% of GDP.

CONCLUSIONS

We now come back to one of our earlier points where we remarked that what counts for capital markets over the shorter run is the prevailing bias of perception. As long as the adhesive of confidence keeps things together, even negative developments can be viewed opportunistically and positively.

Above all, most international investors and currency speculators apparently focus on one element: the determination on the part of the authorities of these deficit countries to defend their currencies. To investors, that still spells short-term opportunity.

Little thought is given to the actual desperation of the situation that these deficit economies find themselves within. Over the long run, present policies and perverse market responses can ultimately only devolve into disastrous consequences for the deficit economies and their currencies.

Despite the alleged impediments of gaping deficits, high interest rates and overvalued currencies, aren't these economies bristling with vim and vitality and aren't they sporting superior growth performance and high employment growth?

The fact is that the general obsession with employment growth has camouflaged and distracted attention from the deeper-seated, corrosive impacts of (both past and present) fiscal excesses and monetary policy on the warp and weft of the economy.

In the meantime, the resulting excesses and global imbalances continue to worsen under the aegis and complicity of international credit markets, furthered and fostered by an attitude of "don't worry" confidence.

To repeat part of the quotation from Mr. Alan Greenspan found on the first page: "The deficit already has begun to eat away at the foundation of our economic strength." It was in this context that he made the remark: "The long run is rapidly turning into the short run."

As a matter of fact, the economic news from the other deficit economies - the inflationary, high-interest nations of Britain, Canada and Australia - are quite similar. Signs of rapidly weakening economies begin to abound in all of them.

Of course, given their overheated conditions, some slowdown is desirable. But what we see everywhere is the wrong kind of a slowdown. As the central banks try to squeeze excess demand and inflation out of their economies, the excessively high exchange rates selectively hit the manufacturing sectors and push the trade balances deeper into the red. On the other had, the service sectors - being insensitive to exchange rates - remain largely unscathed and continue to expand.

As cyclical dynamics again converge with the negative secular trend, stagnating U.S. productivity will come to play in the form of again-rising trade deficits and an intractable inflation bias thus further stressing the faith of international financial markets.

As we stated in our last letter, the bells begin tolling from afar. It seems that this epic thriller is already very near the last chapter. It is now only a matter of time before the villainous "trigger" makes its appearance and concludes this international lending spree like all others.

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